PREFERRED STOCKS AS INVESTMENTS

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The modern security investment field is so broad that intelligent knowledge on the part of the average investor can only be gained by following the opinions of those who specialize in their study of the different classes of investments. Twenty-five years ago it was comparatively easy to acquire a sound knowledge of the general investment field, and to pass judgment on the stock and bond issues which made up the bulk of the market transactions in those days.

But with the great development in corporate enterprise throughout all lines of production and distribution, which has been the chief characteristic of the last generation, the different types of securities have multiplied in number to an almost unlimited extent. While as late as 1890 a general opinion could be safely passed on stock investments as a class, the different types of stocks which are daily sought for investment nowadays are often so different in their characteristics and general position that not only must each class be judged by itself, but a great many issues of the same general class have distinct traits which go far to affect directly their position and value as investments.

Generally speaking, a preferred stock of a railroad or other corporation is in a more desirable investment position than is a common or ordinary stock. But this is not universally the case, and there are numerous issues of ordinary or common stocks which are more attractive as investments than even the preferred stocks or bond issues of the same corporations.

A preferred stock is ordinarily an issue which is limited in authorized amount, and has a preference in its claim on the divisible profits of the corporation up to a certain percentage. In some cases a preferred stock will have a prior claim on the assets of the corporation, so that in the case of dissolution preferred stockholders would

be satisfied up to the par value of their shares before the common stockholders received any of their principal.

In the railroad investment field it will be found that preferred stock issues abound with different characteristics which bear on their interest in the properties or in its profits. Thus, a preferred stock issue of the simplest type, like that of the Union Pacific Railroad, has a prior claim to dividends at the rate of 4 per cent. per annum, when earned, but has no interest whatever in any further amount of the profits which may in any one year be available for dividend distribution. An issue of this kind also has a prior claim on the assets up to its par value before the common stock comes in for any interest in the latter.

The terms of preference, as outlined for the Union Pacific Railroad above, are the ones which have usually been followed in the formation of the large railroad corporations during the past ten or fifteen years. Many of the earlier railroad organizations, however, issued preferred stock which carried other rights as to both dividend payments and interest in assets, etc. For example, the preferred stock of the Chicago, Milwaukee and St. Paul Railway has a prior claim to 7 per cent. non-cumulative dividends, after which the common stock is entitled to receive 7 per cent., and thereafter both common and preferred stock share alike in any further dividend disbursements. In the case of the Chicago and Northwestern Railway, the preferred has a prior claim to 7 per cent., then the common stock to 7 per cent., then the preferred stock has a further preference to 3 per cent., then the common to 3 per cent. more, after which both stocks share pro rata in any further distribution.

In the case of the Erie Railroad there are two issues of preferred stock, each of which is respectively preferred as to assets, and also has preference to 4 per cent. non-cumulative dividends. A unique feature in the case of the Erie Railroad is that both the preferred and common stockholders share their voting power with the first consolidated mortgage bonds of the company. Another feature which is characteristic of this company, and of a number of other railroads, is that both of the issues of preferred stock are redeemable at par at the option of the company.

Other characteristics which differentiate the preferred stock issue from the ordinary kind are related to the voting power. While in the railroad field the great majority of preferred stock issues have

equal voting power with the common stock, some of them have not. For example, the Evansville and Terre Haute Railroad preferred stock issue is entitled to 5 per cent. non-cumulative dividends, but has no voting power whatever. In other cases we find that the voting power is limited to such time as that in which dividends are discontinued or not paid.

It will often be found that a preferred stock issue carries some convertible provision whereby it may, at the option of the holder, be converted into common stock of the same company. This provision was a characteristic of the preferred stock of the Southern Pacific Company, and the holder had the right, at any time, to exchange his shares for common stock. Usually, however, where a preferred stock is convertible into common, it is also redeemable at the option of the company itself at some fixed price. The Southern Pacific stock, above mentioned, was redeemable up to July, 1909, at the option of the company at 115, and was redeemed at the expiration of the option.

In the case of the Reading Company, we find that there are two classes of preferred stock, both being entitled to 4 per cent. non-cumulative dividends, and both being subject to call at the par value. But the further proviso is made that the company shall have the right, at its own option, to convert the second preferred stock, one-half into first preferred and one-half into common stock, at par. The result of this latter provision is that the second preferred stock of the Reading Company sells higher than the first preferred, for while both receive the same amount of dividends, the possibility that the second preferred may some day be converted one-half into the more valuable 6 per cent. common stock gives the issue an added market value.

Probably the most unique arrangement in the railroad preferred stock field is that which we find in the Rock Island Company. The preferred stock of this company is entitled to dividends at the rate of 5 per cent. up to 1916, and 6 per cent. thereafter, and the holders of the preferred issue have the right to elect a majority of the directors of the company. Thus, the company is controlled at all times by the preferred stockholders, for although the common stockholders have voting power, they can elect only a minority of the directors.

In the industrial field it will generally be found that the preferred

stock provisions are more uniform than in the railroad field. Most of the industrial corporations have been formed within the past ten or fifteen years, and the preferred stock issues in nearly all cases represented at the time of formation the physical value of the plants consolidated, while the common stock generally represented the capitalization of future profits or simple voting power. The great majority of the industrial preferred stocks carry prior right to 6 or 7 per cent. dividends, and in a number of cases the dividends are cumulative. Not many of the industrial preferred stocks are callable by the company at any fixed price, and a large part of them represent a first claim on assets, as there are few bond issues outstanding on the big industrial corporations as compared with the vast number of bonds which have been issued by the railroad systems.

In public utility enterprises we find a smaller proportion of preferred stock issues than among the industrials and the railroads. At the same time, it is true that within the past half-dozen years a good many public utility preferred stock issues have been created and are nowadays being sold and quoted in the investment markets.

In approaching the subject of stock investments, as distinguished from bond investments, the student should bear in mind certain fundamental facts which differentiate one class from the other. Briefly, a man who invests money in a bond issue is simply loaning his capital to the business, whereas he who invests in a stock is buying a part of the business. The ordinary stockholder in any corporate enterprise is in precisely the same position as the partner of a firm who is advancing a part of the capital. This is true whether the enterprise happens to be a steam railroad, an industrial or a public utility organization. The key to his position as a holder of the shares will always be the question of profits.

On the other hand, when a person loans funds to a business undertaking, and receives some sort of security therefor, the primary fact in which he should be interested is not necessarily the amount of profits, but the value and character of the property which is given as security for the loan. The purchaser of an ordinary bond in any corporate undertaking is in exactly this position. As the stockholder is the owner, the bondholder is the loaner.

But among these two general types of corporate securities there are many classes which partake more or less of the characteristics of both. In the characteristics of stocks the relationship to the

partnership principle is qualified in many instances and to great degree. Thus it is in the case of the stock which is preferred as to position. As indicated in the examples given above, the preference is often limited to a prior claim on the earning power or profits; in other instances this covers also the tangible assets of the corporation in the event of liquidation, and in still other cases it embraces also the voting power, the preferred stockholders sometimes having a voting privilege to the exclusion of all other stockholders and, at other times having no voting privileges whatever.

It will be readily seen that an intelligent estimate of the investment value of any preferred stock issue must involve the examination of much more than the mere legal or technical characteristics. It must involve, first of all, an examination of the earning power of the property itself. All the legal verbiage in the world will not give a preferred stock real value if the income of the corporation itself is not sufficient to assure the dividend payments, and if the equity back of the issue is not large enough substantially to exceed the par value of the principal. The technical characteristics of both Chicago, Milwaukee and St. Paul preferred and of Minneapolis and St. Louis preferred are much the same; but while the former sells at over 160 per share, the latter is quoted at less than half this price. In the one case, the full dividend is being earned several times over, and has been paid for many years, while in the other the full dividend is not earned, and no margin of surplus is reported on the rate which is being disbursed.

While a preferred stock is not a mortgage, and is in many ways essentially different from most bond issues, its investment position will often be affected by the same factors which affect the worth of a bond. For, like a bond, its income return is fixed, and no matter to what extent the net earnings of the property may grow, its dividend rate cannot be raised above the limit which the terms of its issue provide. A common stock, on the other hand, has a very direct interest in growing profits and in the expansion in the value of equities; and conversely is apt to be more directly affected by declines in profits and shrinkage in equity values. For illustration, take the case of Union Pacific preferred as a representative preferred stock issue and compare it with the common stock of the same company. The Union Pacific Railroad has shown practically steady growth in earning power and surplus for the entire ten years

past, and the property is worth at least double to-day what it was ten years ago. During this entire ten years the 4 per cent. preferred dividend has always been earned several times over, but its market value is no greater to-day than it was half a dozen years ago. On the other hand, very pronounced changes have taken place in both the dividends and market value of the common stock. The latter issue, not being limited as to dividends, has directly reflected the growth of the property in earning power, and is generally regarded as a more attractive investment to-day at 180 than it was at 60 ten years ago.

So it will be seen that the worth of a standard preferred stock issue, which is assured of its dividends, may easily lag far behind the junior common issue in connection with the growth of the property in value and earning power. While the weaker preferred stock issues, which are surrounded with speculative uncertainties, may naturally hope for future growth in value as the property itself develops, this cannot be said of those issues which have already reached a high investment plane. For as soon as the latter plane is reached they become directly responsive to the same influences which affect the average well-secured bond issue. The price changes depend primarily on other factors than that of the earnings of the corporation.

To illustrate this matter, let us consider the effect of general interest rates on securities of the higher investment type. Among the very best of the standard railroad bond issues are numbered Lake Shore 3½s, Chicago, Milwaukee and St. Paul 4s, Baltimore and Ohio 3½s and Union Pacific first 4s. The margin of surplus income back of all these bonds is enormous, and in recent years has been far heavier than was the case eight or ten years ago. And yet we see all these bonds selling from 10 per cent. to 17 per cent. below the quotations of 1901 or 1902. While the security has apparently been growing, the actual market value has been declining in response to the upward trend in the world's money rate. And precisely the same effect is shown in the cases of those preferred stock issues which are far removed from speculative influences, and which are entirely assured of their dividend payments.

In fact, there is a distinct divisional line running across the entire field of corporate investments which should always be clearly recognized by those who seek intelligent investment of funds. This

line does not follow the superficial division such as distinguishes a bond issue from a stock, or a preferred stock issue from a common stock. A bond, *per se,* is not necessarily any better or as good as a stock. Many preferred and common stocks are far superior in strength and value to many bond issues, and the mere fact that a bond is a mortgage, and that the holder thereof is legally entitled to a fixed return on the mortgage, will not of itself necessarily put him in a position of better security than that occupied by one who holds common or preferred stock in a corporation which is not a mortgage and which has only a junior claim on income.

The relative position of different securities in relation to the earning power results in dividing them into two great classes. These two classes may be briefly defined as follows:

1. Securities which are beyond or above the influences of fluctuating earning power, and

2. Securities, the values of which are almost exclusively affected by changes in earning power.

Preferred stocks which have heavy equities back of them, and which are entirely assured of their dividends, are, with high-grade bond issues, in the first class. Common or ordinary stocks, preferred stocks based on relatively small equities, and many junior or low-grade bond issues are of the second class. Even the very highest grade common stocks are not in the first class. Standard Oil, selling at 700; Delaware, Lackawanna and Western, selling at 600, are in the second group, just as is Erie common, selling at 27, or Wabash common, selling at 20. Changes in earning power and net income are steadily reflected in the prices of the latter issues, while changes in prevailing money rates and general conditions are regularly reflected in the prices of the other group.

It should, therefore, first of all be borne in mind that well-matured preferred stock issues possess little attractiveness from the speculative point of view. Like standard and tested bond issues, they are confined almost entirely to the investment field. But as investments they offer in many cases inducements of an exceptional nature. Many investors persist in confining their commitments to bond issues, simply because they have a vague notion that a bond is necessarily a sounder investment than a stock. For this reason, bonds which are relatively no stronger than certain preferred stocks often sell at much higher prices. They are sought for by estates,

institutions, savings banks and large investors to such an extent that often the average yield will be less than 4 per cent., whereas certain preferred stocks which really have greater inherent strength will be quoted on a basis to yield from 4½ to 5 per cent. For example, Baltimore and Ohio Southwestern 3½s will be quoted on a basis to yield but 4¼ per cent., when Atchison preferred will be selling at a price to yield nearly 5 per cent. For all practical purposes, Atchison preferred is fully as secure an investment as the bond issue mentioned, in spite of the fact that the bonds are a first mortgage on an important extension of the Baltimore and Ohio system. And in view of the difference in the income yield, the stock offers features of attractiveness that the bonds do not.

If we turn to the field of industrial preferred stocks, we will find this prejudice against preferred issues still further accentuated. Many of the larger industrial corporations have now been in existence for a decade or more. The permanence of their earning capacity has, therefore, been well demonstrated, and the records show in numerous cases steady expansion in earning power, in value of equities, and in general business stability. In more than one case the margin of safety above the preferred dividend requirement has been earned half a dozen times over for the entire decade. And yet we will find, as a rule, that these preferred issues are regularly quoted on a far lower investment plane than many of the railroad preferred issues which have a much lighter margin for protection, and decidedly under the prices of many semi-speculative railroad bonds whose future can by no means be regarded as entirely assured.

A case in point is that of United States Steel preferred. Even the most drastic falling off in business could hardly interrupt the dividend payments on this issue. Eight years ago this could not have been asserted, but since that day the Steel Corporation has so enormously increased its equities in natural resources, developed its organization, and invested such remarkable sums in manufacturing plants, railroads and terminals, without expanding its liabilities to any important extent whatever, that the payment of 7 per cent. on its preferred stock issue to-day is almost as fully assured as the payment of a like dividend on a railroad stock like St. Paul preferred. And yet, while St. Paul preferred is quoted on a 4 per cent. basis, Steel preferred still yields nearly 5¾ per cent. Many other parallel cases could be cited.

To sum up the question of judging preferred stocks as investments, let it first be said that each issue should be considered by itself in its relationship to the earning power of the corporation. If it is desired to speculate in future growth in profits, the lower grade preferred issues will be found frequently to offer inducements. If, however, true investment value is to be looked for, the investment should be confined to issues which are backed by available income equal to at least twice their dividend requirement. If they have shown results of this kind for a reasonable season, through a period of business depression or hard times, they can generally be regarded as in the class of safe investments, whether in the railroad or industrial field.